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IN THE
SUPREME COURT OF THE UNITED STATES

SECURITIES AND EXCHANGE COMMISSION,

Petitioner,

v.

CHARLES ZANDFORD,

Respondent.

On Writ of Certiorari To The United States Court of Appeals For the Fourth Circuit

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BRIEF *AMICI CURIAE* OF AARP, NATIONAL ASSOCIATION OF SECURITIES AND COMMERCIAL LAW ATTORNEYS, AND CONSUMER FEDERATION OF AMERICA IN SUPPORT OF PETITIONER

DEBORAH M. ZUCKERMAN*
STACY J. CANAN
AARP FOUNDATION

MICHAEL R. SCHUSTER
AARP

601 E Street, N.W.
Washington, DC 20049
(202) 434-2060

Counsel for AARP
*Counsel of Record

(Additional Counsel Listed on Inside Cover)

34pp

ADDITIONAL COUNSEL

Brian Murray
Rabin & Peckel LLP
275 Madison Avenue
New York, N.Y.10016
(212) 682-1818

Denise Davis Schwartzman
Chimicles & Tikellis LLP
361 W. Lancaster Avenue
Haverford, PA 19041
(610) 642-8500

Kevin Roddy
Hagens Berman, LLP
700 S. Flower Street
Suite 2940
Los Angeles, CA 90017
(213) 330-7150

Counsel for National
Association of Securities
and Commercial Law Attorneys

Mary Ellen Fise
Consumer Federation
of America
1424 16th Street, N.W.
Suite 604
Washington DC 20036
(202) 387-6121

Counsel for Consumer
Federation of America

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BRIEF *AMICI CURIAE* OF AARP, NATIONAL ASSOCIATION OF SECURITIES AND COMMERCIAL LAW ATTORNEYS, AND CONSUMER FEDERATION OF AMERICA IN SUPPORT OF PETITIONER

INTEREST OF *AMICI CURIAE*[1/]

AARP is a non-profit, non-partisan organization with more than 35 million members, dedicated to addressing the needs and interests of Americans aged 50 and older. As the largest membership organization representing the interests of older Americans, AARP is very concerned about fraudulent

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[1/] The parties' consents have been filed with the Clerk of the Court. *Amici curiae* state that no counsel for any party authored this brief in whole or in part and that no party other than these *amici curiae*, their members or counsel made a monetary contribution to the preparation or submission of this brief.

practices in the securities industry. Older people are frequent targets of fraud because they often have significant assets and are looking for investment opportunities that will supplement the Social Security and pension benefits they will receive during retirement. As a result, AARP has made the need to combat securities fraud a high priority, with a particular focus on stockbroker practices that are inconsistent with an investor's best interests. AARP has been very involved in commenting on legislative and regulatory proposals that address such practices, has filed *amicus curiae* briefs in cases involving interpretation of the federal securities laws, e.g., *Kauthar Sdn Bhd v. Sternberg*, No. 98-799 (U.S. Supreme Court Dec. 17, 1998) (in support of petition for writ of *certiorari*); *Newton, et al. v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., et al.*, No. 96-5045 (3d Cir. July 17, 1997) (in support of petition for rehearing with suggestion for rehearing *en banc*), and has opposed efforts to limit federal statutory remedies that allow defrauded investors to obtain financial redress. In addition, AARP has undertaken efforts to combat investors' low financial literacy and to educate them about how to choose financial professionals who will act in their best financial interest. For example, in 1998 AARP commissioned a survey of people 50 and older to determine investor awareness of broker compensation practices. The survey revealed that investors do not have a basic understanding of the conflicts of interest that may arise because of such practices, such as sales contests and higher commissions for the sale of proprietary products. AARP, Investor Awareness of Broker Compensation Practices: Findings From An AARP Survey 3-4 (Apr. 1998) (on file with AARP); *see also* AARP, Investor Understanding of Broker Account Statements: Findings From a Survey 5-6, *available at* http://research.aarp.org/consume/broker.pdf (Oct. 2000) (revealing that experienced investors with full-service brokerage accounts do not understand much of the information on typical account statements, including basic terms such as "equity," or fundamental transactions, such as the number of shares reinvested in a particular fund).

The National Association of Securities and Commercial Law Attorneys ("NASCAT") is an association of law firms

and attorneys who litigate antitrust, commercial, consumer, securities fraud, and shareholder derivative cases in federal and state courts throughout the country. NASCAT and its members are devoted to representing victims of corporate abuse, fraudulent schemes, and so-called "white-collar" criminal activity in cases that have the potential for advancing the state of the law, educating the public, modifying corporate behavior, and/or improving access to justice and compensation for the wrongs inflicted upon victims. NASCAT advocates principled interpretation and application of federal and state securities laws to protect investors from manipulative, deceptive, and fraudulent practices and to ensure that the nation's securities markets operate fairly and efficiently. NASCAT's members frequently represent victims of securities fraud in cases brought under federal and state securities laws and thus have an interest in the effective private enforcement of these laws.

The Consumer Federation of America ("CFA") is a non-profit association organized in 1968 to advance the interests of consumers through advocacy and education. CFA's membership is comprised of 285 national, state, and local consumer groups throughout the United States which, in turn, represent more than 50 million consumers. Recognizing the growing participation of American consumers in our nation's financial markets, CFA has made protecting the interests of individual investors a priority. The guiding principles behind CFA's work on these issues is that investors deserve effective protection from fraud, fair dealing from financial professionals, and full and timely disclosure of information relevant to their interests. In keeping with these concerns, CFA has supported federal and state legislative and regulatory initiatives on a broad array of investor protection issues, including financial planner regulation, penny stock fraud, rights to redress for victims of securities fraud (both in court and through arbitration), industry compensation practices, and plain language disclosures.

The interest of *amici* in this case stems from their positions among the leading consumer organizations in this country involved in matters that concern protecting investors

from fraud and the substantial interests at stake for their members and the consumers they serve. *Amici* submit this brief to apprise the Court of the unprecedented degree to which Americans are investing in the securities markets and their relatively low level of understanding of how the markets operate, and to more fully explain the effect the Fourth Circuit's erroneous interpretation of the "in connection with" requirement will have in undermining securities law enforcement and the protections currently afforded investors and the national securities markets by the anti-fraud provisions of § 10(b) of the Securities Exchange Act of 1934 ("the Exchange Act"), 15 U.S.C. § 78j(b) (2001), and Rule 10b-5, 17 C.F.R. § 240.10b-5 (2001), promulgated by the Securities and Exchange Commission ("SEC").

SUMMARY OF ARGUMENT

The Fourth Circuit erred in holding that "Zandford's fraudulent actions were not sufficiently connected with a securities transaction" to support an SEC enforcement action under the federal securities laws. *SEC v. Zandford*, 238 F.3d 559, 561 (4th Cir. 2001), *cert. granted*, 2001 U.S. LEXIS 10303 (Nov. 8, 2001). Not only did the lower court misread the plain language of the Exchange Act and Rule 10b-5, it also misapplied this Court's precedent. The importance of the Court correcting the Fourth Circuit's error cannot be overstated.

In recent years, Americans have entered our nation's securities markets in record numbers, many for the first time. This is due, in large part, to the recognition that individuals have to plan and provide for their retirement security, with less reliance on Social Security and traditional employer-sponsored defined benefit pension plans. Yet, many investors are ill-equipped to navigate the complexities of the markets and thus rely on the advice of a range of professionals, including stockbrokers and financial planners. In placing their trust in others they are, in many instances, unwittingly placing their financial security in jeopardy. When the worst happens, and their trust is abused through fraud, individual investors need access to the full range of legal enforcement

mechanisms and remedies – federal and state, public and private, civil and criminal – that Congress and state legislatures have enacted for their protection.

Unless the Court reverses the Fourth Circuit and upholds the standard intended by Congress and advanced by Petitioner America's individual investors and their financial futures will remain at the mercy of unscrupulous practitioners. At the same time, the SEC's civil enforcement authority and the ability of individual investors to seek redress will be severely circumscribed. The result will be the severe dilution of two powerful weapons in the full arsenal of legal protections intended to benefit investors.

ARGUMENT

I. INTRODUCTION

A. Individuals Are Investing in the Securities Markets in Unprecedented Numbers, Often For the First Time

Demographic factors have led to considerable changes in participation in this country's securities markets. In the past, wealthy individuals and corporations were the primary investors in the stock market. That is no longer true, due to the combined effect of the baby boom generation's entry into adulthood, changes in retirement regulations and strategies, and a stock market that, for the most part, has been producing incredibly high returns. The nation has entered a period in which Social Security provides proportionately less of needed retirement income, and traditional employer-sponsored defined benefit pension coverage has decreased. In addition, Americans have departed, in unprecedented numbers, from their historic practice of placing primary reliance on federally-insured products, such as savings accounts and certificates of deposit, for their retirement needs.

A recent Investment Company Institute (ICI)[2/] survey of the mutual fund industry showed that the combined assets of the nation's mutual funds totaled $6.616 trillion in October 2001. Investment Company Institute, Mutual Funds Facts & Figures, Current Statistical Releases, Trends in Mutual Fund Investing, *available at* http://www.ici.org/facts_figures/trends_1001.html (Nov. 29, 2001). The ICI also indicates that as of May 2001, an estimated 93 million individuals in 54.8 million American households, or 52% of all U.S. households, owned mutual funds. Mutual fund ownership among U.S. households increased steadily during the 1990s and, in 2000, one out of three individuals in the country owned mutual funds. Investment Company Institute, About Mutual Fund Shareholders, Demographic Information, Frequently Asked Questions About Mutual Fund Shareholders (Nov. 2001) [hereinafter Frequently Asked Questions] *available at* http://www.ici.org/aboutshareholders/shareholders_faqs.html.

The increased number of individuals making mutual fund purchases is due, in large part, to the significant trend toward replacing defined benefit pension plans with defined contribution plans. The ICI reported that 62% of fund shareholders own funds through defined contribution retirement plans. *Id.*; *see also* Office of Investor Education and Assistance, SEC, The Facts on Saving and Investing 6 (Apr. 1999) [hereinafter SEC, The Facts on Saving and Investing]. This increased reliance on defined contribution plans places significant responsibility on individuals to make appropriate investment choices so they will have adequate retirement income. When mutual fund assets typically represent 40% of household assets, ICI, Frequently Asked Questions, *supra*, investors face a heightened risk if they incur losses due to bad advice, abusive practices, or fraud. The potential for fraud and other abuses becomes even greater

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[2/] The Investment Company Institute is the national association of the American investment company industry. Founded in 1940, its membership includes 8,710 mutual funds, 481 closed-end funds, and 7 sponsors of unit investment trusts.

as large numbers of first-time investors enter the securities markets and, due to their relative lack of sophistication and high financial illiteracy, rely on a range of professionals, including stockbrokers and financial planners, to advise them in the purchase or sale of securities.

B. Individual Investors Have Extremely Low Levels of "Financial Literacy" Leading Them to Rely Heavily on Financial Professionals

The complexity of the marketplace and the relative lack of sophistication of a majority of individual investors combine to hinder their ability to make wise investment decisions. "America faces a financial literacy crisis. At a time when more Americans than ever before are investing in our securities markets through the purchase and sale of stocks, bonds, and mutual funds, numerous studies show they lack the financial basics." SEC, The Facts on Saving and Investing, *supra*, at 2.

Then-SEC Chairman Levitt stated that

> [t]ens of millions of Americans lack the basic saving and investing information they need to prepare for retirement or to meet other financial goals. . . . While 63 percent know the difference between a halfback and a quarterback, only 12 percent know the difference between a load and a no-load mutual fund.

Arthur Levitt, Expanding the Promise of Opportunity and Security Through Savings and Investing, Remarks Before the Consumer Federation of America, *available at* http://www.sec.gov/news/speech/speecharchive/1998/spch229.htm (Dec. 3, 1998).

Several recent studies conducted by government agencies, financial services corporations, and non-profit organizations have produced remarkable findings that bear out Chairman Levitt's concerns. The studies took different approaches but

reached the same conclusion: individual investors lack even the most rudimentary knowledge needed to make informed investment decisions. Investors do not know the basics of how investments work, and they do not even know what they are doing with their own money. For example, a May 1996 study conducted by the National Association of Securities Dealers (NASD) found that while 78% of Americans can name a character on a television sitcom, a mere 14% know the difference between growth and income stocks. Press Release, National Association of Securities Dealers, Inc., NASD Launches Major Public Disclosure, Investor Education Initiative (Feb. 19, 1997) (on file with AARP); *see also* Ruth Simon, *We Put Investors to the Test -- and, Boy, Did They Ever Flunk*, Money, Mar. 1998, at 37 (reporting on results of MONEY/Vanguard Mutual Fund Literacy Test on which mutual fund investors scored an average of just 51 out of 100); Towers Perrin, Preparing For Retirement: A Survey of 1,000 Working Americans 9 (Feb. 1995) (one-third of those who participate in a 401(k) or other retirement savings plan think there is no risk associated with bonds, and 14% think there is no risk associated with an investment in a "mutual fund" or a "balanced" fund) (reports on file with AARP).

Unfortunately, these findings have not improved with time. The Securities Investor Protection Corporation and the National Association of Investors Corporation recently reported that 85% of American investors do not know enough to pass a "survival" quiz designed to assess their knowledge of what to do in times of market downturns and other financial difficulties. For example, almost two in three investors do not know the first step to take when they suspect they are dealing with a problem broker, and fewer than one in five knows there is no insurance for stock market losses. Press Release, Securities Investor Protection Corporation & National Association of Investors Corporation, Survey: More Than 4 Out of 5 U.S. Investors Fail Quiz of Basic "Survival" Knowledge, *available at* http://216.181.142.217/sipc/release0.html (Aug. 1, 2001).

The only conclusion to be drawn from this sampling of findings is that individual investors do not know the ABCs of investing. Lacking this basic knowledge of how the securities markets operate, and being unaware of the fundamental features of their own investments, individual investors rely in large measure on third parties, such as brokers, for advice on the purchase and sale of securities. More than 80% of new mutual fund purchases were made through intermediaries such as brokers, banks, financial planners, insurance agents, and employers,[3/] and 37% of shareholders purchase funds primarily through full-service brokers, insurance agents, financial planners, or bank representatives. ICI, Frequently Asked Questions, *supra*. In spite of this, almost four-fifths (79%) of investors feel it is difficult to know how to choose a good professional investment advisor. SEC, The Facts on Saving and Investing, *supra*, at 24. And, the vast majority of investors (88%) who have received advice from a financial professional have never looked into the disciplinary history of their broker or financial planner. Press Release, Investor Protection Trust, National Association of Securities Dealers, North American Securities Administrators Association, Survey: Financial Illiteracy, Bad Habits Dangerous Mix For Investors, *available at* http://www.investorprotection.org/nr1.htm (May 14, 1996). Individual investors' lack of knowledge about the securities markets, their own investments, and how to choose trustworthy financial professionals place these investors at great risk of being defrauded by unscrupulous practitioners.

[3/]Nearly half (48%) of mutual fund shareholders identified an employer-sponsored retirement plan as their primary method for purchasing mutual funds, and 57% bought their first fund through these plans. ICI, Frequently Asked Questions, *supra*.

II. THE PREVALENCE OF SECURITIES FRAUD REQUIRES THAT THE SEC & INVESTORS HAVE A FULL RANGE OF STRONG, FLEXIBLE ENFORCEMENT TOOLS.

A. Securities Fraud Continues to Plague Investors

"We are living in a time when the stock market is more a part of the American consciousness than ever before." SEC Chairman Arthur Levitt, Remarks to National Press Club, Plain Talk About On-line Investing (May 4, 1999).[4/] Thus, protection against fraud is more important than ever. State regulators estimate that securities fraud costs Americans billions of dollars each year. Press Release, North American Securities Administrators Association, "Top 10 Investment Scams" List Released by State Securities Regulators, *available at* http//www.nasaa.org/nasaa/scripts/prel_display.asp?rcid=156 (Apr. 23, 2001). The excesses of the 1980s, which gave rise to spectacular failures of financial firms,[5/]

[4/] The stock market has been characterized by one commentator as a kind of magic. "Investors pay enormous amounts of money for completely intangible rights whose value depends entirely on the quality of the information that investors receive and the honesty of other people about whom investors know almost nothing. This magic does not appear in unregulated markets." Bernard Black, *The Core Institutions that Support Strong Securities Markets*, 55 Bus. Law. 1565, 1565 (Aug. 2000).

[5/] The highest-flying investment banking firm of the 1980s, Drexel Burnham Lambert pled guilty to federal felony securities fraud charges and paid $650 million in fines and sanctions. *SEC v. Drexel Burnham Lambert, Inc.*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,474 (S.D.N.Y. June 20, 1989) (reflecting entry of consent decree).

junk bonds,[6/] and the collapse of the thrift industry,[7/] threatened a loss of investor confidence in the financial markets with a corresponding negative impact on the ability of business to raise capital. Such apprehensions, however, gave way to the exuberance of the 1990s and the charging bull market that marked the turn of this century. New and enthusiastic investors entered the financial markets[8/] and, as could be expected, those so inclined found new and enthusiastic ways to give honesty the slip and defraud investors.

As Chairman Levitt also observed:

> With this vast expansion in our markets and in public participation in those markets, we would expect to see an increase in the incidence of fraud. We have particularly seen

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[6] The most notorious "financier" of the 1980s, Michael Milken, the "junk bond king," was indicted on 98 counts of RICO and criminal securities fraud, pled guilty to six counts and was sentenced to ten years in prison. *SEC v. Milken*, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,200 (S.D.N.Y. Apr. 24, 1990) (reflecting settlement of civil enforcement action and guilty plea).

[7] President George H. Bush told the nation that "'unconscionable risk-taking, fraud, and outright criminality [were] factors' that led to the savings and loan crisis." Maureen Dowd, *Bush Savings Plan Calls for Sharing the Cost Broadly*, N.Y. Times, Feb. 7, 1989, at A1.

[8] For example, as of 1999, 25% of all individual trades were conducted on line. In 1994 not one person traded over the Internet. Many new Internet investors are inexperienced in any form of investing. Arthur Levitt, Remarks to National Press Club, Plain Talk About On-line Investing (May 4, 1999).

> an increase in abuses in the market for micro cap securities, which . . . provides opportunity for fraudsters to prey on innocent investors.

Fraud In The Micro-Capital Markets, Including Penny Stock Fraud: Hearing Before the Permanent Subcomm. on Investigations of the Senate Comm. on Governmental Affairs, 105th Cong. 114 (1997) (testimony of Arthur Levitt).

The Subcommittee Chair made a similar observation:

> We conduct these hearings against the backdrop of a booming stock market and a new generation of unseasoned investors. Hidden beneath the rising tide of the market, micro-cap fraud represents a pernicious undercurrent that potentially affects thousands of American families. Many of these families are, for the first time, investing their hard-earned money to save for skyrocketing tuition costs, unforeseen medical expenses, and lengthier retirements. While we have the safest and most successful capital markets in the world, the irony is that public confidence in our markets actually creates opportunities for con artists to exploit the unwary.

Id. at 55 (opening statement of Sen. Susan M. Collins).

Fraud is by no means limited to the micro-cap market, and the Senate hearing excerpts merely illustrate the problems faced by investors in many market sectors. For example, major brokerage houses peddled high risk limited partnerships, touting their suitability for conservative and older investors. *See, e.g., Coming to Terms, CSFB Agrees to Pay $100 Million to Settle Twin IPO Investigations,* Wall St. J., Dec. 11, 2001, at A1 (SEC announcing Credit Suisse First Boston will pay $100 million to resolve federal investigation into alleged abuses in distribution of its IPOs); *see also In re Prudential Sec. Inc. Ltd. P'ship Litig.*, 163 F.R.D. 200 (S.D.N.Y. 1995) (describing $110 million settlement with an

investor class growing out of Prudential's fraudulent marketing of 700 limited partnership units); *In re PaineWebber Ltd. P'ship Litig.*, 171 F.R.D. 104, 106 (S.D.N.Y. 1997) (approving $200 million settlement in action growing out of limited partnership sales). Fraudulent accounting practices remain a fertile source of Section 10(b) and Rule 10b-5 violations. *See In re Cendant Corp. Litig.*, 264 F.3d 286, 288 (3d Cir. 2001) (approving settlement for investor class of $2.85 billion in cash from the corporation and $335 million from Ernst & Young based on accounting fraud).

All of these practices can, and often do, wipe out savings accumulated during a person's lifetime for use during retirement. This underscores the importance of ensuring that investors victimized by these frauds can access the public and private enforcement mechanisms Congress provided for their benefit.

B. SEC Enforcement Actions & Private Lawsuits Are Powerful Tools Under The Exchange Act and Should Not Be Weakened

1. Congress Gave the SEC Broad Powers to Combat Fraud Under the Federal Securities Laws

The strength and stability of America's securities markets depend on investor confidence in the fairness and efficiency of the marketplace. Critical to maintaining this confidence is the availability of effective remedies against those who violate federal anti-fraud provisions. Congress recognized this need when it enacted Section 10(b) of the Exchange Act "'to deter fraud and manipulative practices in the securities markets, and to ensure full disclosure of information material to investment decisions[.]'" *Musick, Peeler & Garrett v. Employers Ins. of Wausau*, 508 U.S. 286, 296 (1993) (quoting *Randall v. Loftsgaarden*, 478 U.S. 647, 664 (1986)). As the Second Circuit pointed out in *United States v. Benjamin*, 328 F.2d 854, 863 (2d Cir.), *cert. denied*, 377 U.S. 953 (1964), compensating defrauded investors is another essential purpose

of the Exchange Act. In order to accomplish these goals effectively, the SEC's civil enforcement powers must remain as broad and flexible as possible.

The extensive hearings that preceded passage of the Exchange Act touched only briefly on Section 10, with most of the discussion devoted to the specifically enumerated devices the SEC would be empowered to proscribe under Section 10(a). The most relevant exposition of the provision that was to become Section 10(b) was provided by Thomas G. Corcoran, a spokesman for the drafters.

> "Subsection (c) [§ 9 (c) of H.R. 7852 - later § 10(b)] says, 'Thou shalt not devise any other cunning devices'. . . . Of course subsection (c) is a catch-all clause to prevent manipulative devices. I do not think there is any objection to that kind of clause. The Commission should have the authority to deal with new manipulative devices."

Ernst & Ernst v. Hochfelder, 425 U.S. 185, 202 (1976) (quoting *Hearings on H.R. 7852 and H.R. 8720 before the House Comm. on Interstate and Foreign Commerce*, 73d Cong. 115 (1934)). Very little has changed in this regard since 1934; the parameters of fraud differ only by the ingenuity of the perpetrators.

Section 10(b) and Rule 10b-5 are the core federal provisions that prohibit fraud against investors. The SEC, which promulgated Rule 10b-5 under its authority to enforce the federal securities laws, has stated that "Section 10(b) and Rule 10b-5 have come to embrace a diversity of claims which could not have been envisioned in 1934." Brief of *Amicus Curiae* SEC at 23, *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350 (1991). In addition, a recent General Accounting Office ("GAO") report to Congress concerning staff turnover at the SEC described the agency's primary mission as protecting investors and maintaining the integrity of the securities markets and noted its responsibility for conducting investigations of potential securities law

violations and overseeing self-regulatory organizations, broker-dealers, mutual funds, investment advisors, and public utility holding companies. The GAO report stated that the "SEC's mission has become increasingly important as retail investors have become more involved in the securities markets . . . and as the markets themselves have begun to change, because of the increased use of alternative trading systems and the potential privatization of securities exchanges." U.S. General Accounting Office, Report to the Ranking Minority Member, Subcomm. on Financial Institutions, Senate Comm. on Banking, Housing, and Urban Affairs, "Securities and Exchange Commission: Human Capital Challenges Require Management Attention" 3-4 (Sept. 2001).

Justice Blackmun pointed out in *Aaron v. SEC* that Sections 17(a) of the Securities Act of 1933 and 10(b) of the Exchange Act are "the primary antifraud provisions of the federal securities laws. They are the chief means through which the Commission . . . can seek protection against deception in the marketplace. As a result, they are key weapons in the statutory arsenal for security market integrity and investor confidence." 446 U.S. 680, 704 (1980) (Blackmun, J., dissenting) (citations omitted). For example, the SEC's ability to compel a wrongdoer to disgorge its profits stems in large part from its authority to seek equitable relief in federal court. *See SEC v. Manor Nursing Centers, Inc.*, 458 F.2d 1082, 1103-04 (2d Cir. 1972) (upholding award of ancillary relief where court has authority to fashion appropriate remedy and "effective enforcement of the federal securities law requires that the SEC be able to make violations unprofitable"); *SEC v. Drexel Burnham Lambert, Inc.*, 956 F. Supp. 503, 507 (S.D.N.Y. 1997) (noting that restitution and disgorgement are distinct remedies – the former seeks to make the victim whole, the latter to deprive the wrongdoer of its ill-gotten gains).

2. The Fourth Circuit Erred in Holding That Zandford's Fraud Did Not Meet the "In Connection With" Standard and Thus Fell Outside the SEC's Broad Enforcement Authority

Zandford's fraud meets the "in connection with" standard required by Section 10(b). The Fourth Circuit's articulation of the issue reveals the flaw in its analysis. According to the court below, "[t]he question is not how Zandford stole the money in the Woods' account. Rather it is whether Zandford engaged in manipulation of a particular security." *SEC v. Zandford*, 238 F.3d at 565. Under Section 10(b) of the Exchange Act and related SEC Rule 10b-5, however, the pertinent question is whether Zandford employed a scheme to defraud in connection with the purchase or sale of a security. The SEC alleged that an integral part of the scheme in which Zandford had engaged to defraud the Woods involved the sale of securities. That is all the federal securities laws require; they do not require the manipulation of a particular security. Moreover, the Fourth Circuit labored under the misimpression that all securities fraud involves sophisticated schemes to manipulate the market for a particular stock. While this may occur in the majority of securities fraud cases brought in the district courts, neither Section 10(b) of the Exchange Act nor Rule 10b-5 contains such a requirement. Fraud actionable under those provisions can be committed with a bludgeon as well as a scalpel. In this case, Zandford used a bludgeon.

The federal securities laws prohibit *fraud* in connection with the purchase or sale of securities, and Zandford committed fraud, in part by selling securities. An examination of the statutory text at issue proves the point. Section 10(b) makes it unlawful for any person "[t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe . . . ." 15 U.S.C. § 78j(b). Pursuant to this statute, the SEC promulgated Rule 10b-5, which states it shall be unlawful for any person, by use of

interstate commerce, mail, or the facilities of any national securities exchange, "to employ any device, scheme, or artifice to defraud" or "[t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security." 17 C.F.R. § 240.10b-5. The plain language makes clear that neither the statute nor the rule requires the manipulation of a particular security, only a course of business that operates as a fraud in connection with the sale of a security. That is exactly what Zandford did in this case.

In finding that the "in connection with" requirement was not met in this case, the Fourth Circuit not only ignored the plain statutory and regulatory language, but also misapplied this Court's opinion in *United States v. O'Hagan*, 521 U.S. 642 (1997).[9/] In *O'Hagan*, the defendant had misappropriated a valuable piece of information and then purchased securities based on this stolen information. The theft and the purchase formed the scheme to defraud. Similarly, in this case, an unauthorized sale of securities was designed to generate proceeds for Zandford to misappropriate. These integrated acts -- the sale and the theft -- constituted the scheme to defraud, and that is all the statute and the rule require.

[9/] The Fourth Circuit's reliance on its decision in *Head v. Head*, 759 F.2d 1172 (4th Cir. 1985), is even more strained. In *Head*, the husband in a divorce proceeding listed certain stock (held only in his name) as an asset at book value (rather than market value). The wife never held an interest in the stock which, at one point, was placed in escrow to secure an obligation that the husband paid off in cash when the obligation came due. The wife later sued the husband for fraud in connection with the divorce settlement when he sold his stock at a price significantly higher than book value. The Fourth Circuit held that there never was a purchase or sale of stock, so any alleged fraud could not be "in connection with" the purchase or sale of a security. *Id.* at 1176.

3. The Fourth Circuit's Error Also Will Restrict Defrauded Investors From Seeking Redress Under the Federal Securities Laws

The Fourth Circuit's extremely narrow reading of the "in connection with" language will severely limit not only the SEC's enforcement authority, but also the rights of individual investors to seek redress under laws enacted for their benefit. The Court and the SEC repeatedly have cited the availability of private lawsuits as critical to effective enforcement of federal securities laws, and to maintenance of investor confidence in the integrity, fairness, and efficiency of the securities marketplace. For example, the Court stated that private actions provide "'a most effective weapon in the enforcement' of the securities laws and are 'a necessary supplement to Commission action.'" *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 310 (1985) (quoting *J. I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964)).

The SEC has echoed this view. In testimony concerning litigation under the federal securities laws, Chairman Levitt stated:

> [T]he Commission has consistently stressed the importance of private actions under the antifraud provisions of the federal securities laws. In order to maintain investor confidence in the fairness of our securities markets, we must ensure that investors have a meaningful right to seek recovery against those who defraud them.

Securities Litigation Reform: Hearings Before the Subcomm. on Telecomm. & Finance of the House Comm. on Energy and Commerce, 103d Cong. 33 (1994) (testimony of Arthur Levitt).

The Director of the SEC's Division of Enforcement expressed similar sentiments:

> Due to the Commission's inability to address all violations, the implied private right of action under Section 10(b) and Rule 10b-5 thereunder is critically important to the effective operation of the federal securities laws. . . . Given the continued growth in the size and complexity of our securities markets, and the absolute certainty that persons seeking to perpetuate financial fraud will always be among us, private actions will continue to be essential to the maintenance of investor protection.

Private Litigation Under the Federal Securities Laws: Hearings Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs, 103d Cong. 111, 113 (1993) (testimony of William R. McLucas).[10/]

[10/] While the industry often argues that Section 10(b) poses a particular danger of vexatious litigation, the Court and Congress already have addressed what were viewed as troubling aspects of Section 10(b) and significantly narrowed and clarified the law's reach. *See, e.g., Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 202 (1976) (holding pleading scienter a requirement under Section 10b); *Blue Chip Stamps v. Manor Drug Store*, 421 U.S. 723, 739 (1975) (permitting damages actions only by active market participants, i.e., purchasers and sellers); *Basic Inc. v. Levinson*, 485 U.S. 224, 249 (1988) (allowing a presumption of reliance under the fraud-on the market theory); *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976) (defining materiality under an objective standard); *Lampf, Pleva Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350, 361-62 (1991) (fixing a uniform statute of limitations for Section 10(b) actions); *Central Bank v. First Interstate Bank*, 511 U.S. 164, 191 (1994) (holding private civil liability does not extend to those who aid or

The Fourth Circuit's error will have widespread consequences for individual investors, affecting private lawsuits as well as arbitration proceedings. Since 1987, the securities industry routinely includes pre-dispute arbitration clauses in its customer agreements.[11] Thus, individual broker-customer disputes only find their way to court in very limited circumstances. If arbitration is to provide a workable forum for recovery on meritorious investor claims and fulfill the purpose of the Exchange Act, the law which the arbitrators apply should be kept as clear as possible. While a bright line rule may be unavailable here, the meaning of "in connection with" that has been followed for years by the courts and arbitrators does provide some measure of certainty.[12] The lower court's articulation of the test narrows the meaning of the language and creates ambiguity. In fact, it is doubtful if the most common claims raised in arbitration,

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abet a violation of Section 10(b)); *see also* Private Securities Litigation Reform Act of 1995 ("PSLRA"), Pub. L. No. 104-67, 109 Stat. 747 (codified as amended in scattered sections of 15 U.S.C. § 78) (heightened pleading standards for private litigants and set new standards for class actions) and Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 (codified as amended in scattered sections of 15 U.S.C. § 78) (precludes class litigants from seeking relief in state court to avoid heightened pleading standards of the PSLRA). Significantly, neither law touched the fundamental statutory scheme defining actionable conduct, including the "in connection with" language.

[11] *Shearson/American Express v. McMahon*, 482 U.S. 220, 238 (1987) (permitting pre-dispute broker-customer arbitration agreements to be enforced even where claims arise under Section 10(b)).

[12] *See Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 11 (1971) (upholding a Section 10(b) claim where the proceeds of a sale were misappropriated).

namely, churning and unauthorized trading,[13] even would be actionable under the Fourth Circuit's interpretation of "in connection with."

Furthermore, because a district court can only vacate an arbitration award if it finds "'manifest disregard of the law' or evidence," *Green v. Progressive Asset Mgmt., Inc.*, 2000 U.S. Dist. LEXIS 12428, at *4 (S.D.N.Y. Aug. 29, 2000) (quoting *Halligan v. Piper Jaffray, Inc.*, 148 F.3d 197, 202 (2d Cir. 1998)), it is particularly important to private litigants that the Court not insert a measure of ambiguity into years of precedent.

C. Neither A State Civil Remedy Nor A Criminal Proceeding Precludes a Claim Under the Federal Securities Laws

The Fourth Circuit found that Zandford's wrongdoing was more akin to a state law tort of conversion than a federal securities law violation. *Zandford*, 238 F.2d at 566. This comparison fails to recognize that the existence of a viable state civil claim or a related criminal proceeding does not bar the SEC or an individual from suing under the federal securities laws.

It is axiomatic that the existence of a remedy in state court does not preclude seeking a remedy for the same course of conduct under the federal securities laws. No lesser an authority than William O. Douglas stated that the difficulties of pleading a cause of action for fraud under state law led to passage of the Securities Act of 1933. *See* William O.

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[13] *See Krull v. SEC*, 248 F.3d 907, 908-909 (9th Cir. 2001) (charging churning and unauthorized trading of front end loaded mutual funds), and *Miley v. Oppenheimer & Co.*, 637 F.2d 318, 323 (5th Cir. 1981) (stating that civil suits alleging excessive trading or "churning" in violation of brokers' common law fiduciary duty and the federal securities laws have dotted the federal docket).

Douglas & George E. Bates, *The Federal Securities Act of 1933*, 43 Yale L.J. 171, 177 (1933) ("Satisfaction of the common-law requirements of fraud raised almost insurmountable barriers to recovery."). Congress enacted the federal securities laws in the 1930s because state law remedies were deemed inadequate to protect investors. *See* President Franklin D. Roosevelt, Regulation of Security Issues, Remarks to the Senate (Mar. 28, 1933), *reprinted in* 77 Cong. Rec. 937 (1933) (stating that "[i]n spite of many state statutes the public in the past has sustained severe losses through practices neither ethical nor honest on the part of many persons and corporations selling securities").

The federal securities laws are meant to co-exist with state laws, and the fact that both state and federal law may provide redress for the same wrongful conduct does not mean that only one or the other should be applied. In fact, in the *O'Hagan* case cited so prominently by the Fourth Circuit, the defendant was convicted of theft in Minnesota state court in addition to being prosecuted under the federal securities laws. 521 U.S. at 648 n.2; *see also Basic Inc. v. Levinson*, 485 U.S. 224, 245 n.22 (1988) (recognizing that actions brought under Section 10(b) are distinct from common law deceit and misrepresentation); *Herman & MacLean v. Huddleston*, 459 U.S. 375, 389 (1983) (stating that actions under Section10(b) are designed, in part, to add to the protections provided to investors by the common law by establishing higher standards of industry conduct).

There are numerous examples of Congress enacting laws that co-exist with state laws that provide remedies for the same wrongful conduct. For example, in 1970 Congress enacted the Racketeer Influenced and Corrupt Organizations Act ("RICO"), 18 U.S.C. §§ 1961-1968. RICO provides a private treble damage remedy for predicate acts which are found to form a pattern of racketeering. Each of the predicate acts would, by definition, give rise to a state law claim. Nevertheless, despite state law or common law remedies for victims, Congress found that the 18th and 19th century jurisprudence available in state courts was ineffective in combating crime. *See* Organized Crime Control Act of 1970,

Pub. L. No. 91-452, 84 Stat. 922, 923 (statement of findings) (stating that "organized crime continues to grow . . . because the sanctions and remedies available to the Government are unnecessarily limited in scope and impact"); *see also United States v. Turkette*, 452 U.S. 576, 586 (1981) (providing that Congress enacted RICO because existing state law was inadequate to address problem).

Nor does the availability of criminal law enforcement preclude a civil action under the federal securities laws. Former Justice Robert Jackson observed that criminal law has "[l]ong proved futile to reach the subtler kinds of fraud at all, and [is] able to reach grosser fraud, only rarely." Robert Jackson, *The Struggle For Judicial Supremacy* 152 (1943). Criminal enforcement by state attorneys general or county prosecutors, by itself, is insufficient to deter securities fraud. Even coupled with criminal prosecutions by the United States Attorneys, and civil proceedings brought by the SEC and private plaintiffs, securities fraud has reached epic proportions, costing Americans billions of dollars annually. *See* Press Release, North American Securities Administrators Association, "Top 10 Investment Scams" List Released by State Securities Regulators, *supra*.

Federal, state, and local prosecutors do not have sufficient personnel to bring enough criminal cases to create an effective deterrent against fraud. The higher burden of proof in a criminal case alone makes civil enforcement actions under the federal securities laws an absolute necessity to deter securities fraud. Moreover, criminal prosecution often does not obtain restitution for victims, a critical remedy available to the SEC and investors under the federal securities laws. When Congress passed the Securities Act there was "so far as criminal law goes, a fair 'arsenal of weapons' to employ against subversive practices during the last decade. Yet little attempt was made to use them, and the failure can hardly be blamed solely upon limited state jurisdiction." William O. Douglas & George E. Bates, *The Federal Securities Act of 1933*, 43 Yale L.J. at 182.

If the SEC's enforcement authority is restricted to the point it cannot challenge such obvious fraudulent conduct in the sale of securities as occurred here, the investing public will have lost an invaluable safeguard and the SEC will have lost a critical weapon.

CONCLUSION

For all of the foregoing reasons, *amici* respectfully request that the Court reverse the Fourth Circuit and retain the federal securities laws as the powerful tools Congress intended.

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Respectfully submitted

Brian Murray
Rabin & Peckel LLP
275 Madison Avenue
New York, N.Y.10016
(212) 682-1818

Denise Davis Schwartzman
Chimicles & Tikellis LLP
361 W. Lancaster Avenue
Haverford, PA 19041
(610) 642-8500

Kevin Roddy
Hagens Berman, LLP
700 S. Flower Street
Suite 2940
Los Angeles, CA 90017
(213) 330-7150
Counsel for NASCAT

Deborah M. Zuckerman*
Stacy J. Canan
AARP Foundation

Michael Schuster
AARP

Counsel for AARP
601 E Street, N.W.
Washington, D.C. 20049
(202) 434-2060

Mary Ellen Fise
Consumer Federation
of America
1424 16th Street, N.W.
Washington DC 20036
(202) 387-6121

Counsel for Consumer
Federation of America

*Counsel of Record